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On the whole, one can say without exaggeration that the practical value of statistical research depends primarily upon the soundness of the theoretical conceptions on which it is based. To decide on the most important problems of the Trade Cycle remains the task of theory.
—*Monetary Theory and the Trade Cycle*, Friedrich A. Hayek, 1933

THE ALL-IMPORTANT QUESTION: PROFITS

Worldwide, the economic news is going from bad to worse. Never before has the world experienced such massive destruction of stock market wealth; never before have business profits and business capital spending suffered such steep declines. Yet there remains, particularly in the United States, a general flat refusal to see anything foreboding in these developments.

Blind faith is overwhelming bad and worsening facts. This faith has two main objects: first, Fed Chairman Alan Greenspan creating money and credit with reckless abandon; and second, the consumer borrowing and spending with equal reckless abandon.

This faith is utterly amazing. But it confirms our long-held suspicion that the American consensus remains at a complete loss to appreciate and understand that the extraordinary excesses of these two, Mr. Greenspan and the consumer, have been crucially responsible for the present economic and financial mess. Even more of the same excesses are hardly the solution. While postponing the day of reckoning, the consumer is ever-worsening his position by loading himself with more debt that he is unable to repay.

We continue to track the chief causes of this developing American economic and financial crisis. Our finding is that they keep worsening. There is nothing in sight that might be regarded as healthy readjustment.

AMERICAN STATISTICS VERSUS EUROPEAN THEORY

In his book *Crises and Cycles*, published in 1936, Wilhelm Röpke, Germany's leading economist at the time, lamented about the general posture of American economists to indulge in the collection of detailed statistics about the economy, simply looking for regular sequences in the business cycle while grossly neglecting analytical research about underlying causes and conditions.

For the great European economists, economics was in essence a branch of logic with minimal statistics; for American economists, it is traditionally a branch of statistics with minimal research and logic.

The main concerns of the European economists were the need for sufficient rates of saving and capital investment as the key sources of wealth creation and productivity growth. For them capital formation was the future. Under the dominating influence of Professor Wesley Mitchell (1874-1948), economic thinking in America took a diametrically different route. He had no interest in the conditions of long-term economic growth. His whole attention centered on the recurrent oscillations in economic activity.

His primary thesis was that each phase of the cyclical oscillations grows out of the preceding phase. Under his influence, the business cycle became a fad with American economists and the business community, and forecasting became a national sport.

With the change in the target of research came a radical change in the kind of research. While the European economists emphasized the need for a theoretical concept to properly assess economic policies and prospects, Mr. Mitchell discarded such abstract theorizing as a useless exercise.

Pointing out that business cycles generally follow the same pattern, Mr. Mitchell advocated that economists should therefore contend themselves in their studies with purely empirical, descriptive analysis. Instead of trying to search with theoretical concepts for causes and conditions, they should look for regular sequences and leads and lags of the significant economic and financial variables, trying to trace unfolding fluctuations.

Putting it briefly and bluntly: While the European economists searched for causes and conditions that determine long-term economic growth and its repeated upheavals, Mr. Mitchell practically turned American economics into a science of statistical symptomatology, refuting the necessity to identify underlying causes and conditions.

Still, although very skeptical of any theory, he emphasized in his writings that the quest for profits is the central factor controlling economic activity. Accordingly, he said the whole discussion must center on the prospects for profits, which is really the theoretical assumption of crucial importance about the workings of the capitalistic economy.

THEY HAD IT IN THEIR GUTS

Is a theoretical concept really so important? In our view, it is indispensable. Looking back over the five decades since World War II, it is true that the industrial economies developed very smoothly and that cyclical fluctuations showed, indeed, the very same pattern as presumed by Mr. Mitchell. There appeared to be no need for a theoretical concept.

But we think that this interpretation is grossly misguided. With the Great Depression in their memory, policymakers, economists, entrepreneurs and the public worldwide entered the postwar period with strict views about what is sound and what is unsound in economics.

They didn't need a theory; they had it in their guts that saving and investment were needed to increase living standards and wealth. Americans were proud of repaying the mortgages on their houses. They would have thought it irresponsible to increase an existing mortgage. In the same vein, deficits in government budgets as well as deficits in the balance of payments were generally abhorred. Minor deteriorations tended to cause prompt and heavy adverse market reactions in the markets, forcing governments to undertake quick, corrective action.

What prevented prolonged spending excesses was, clearly, not only prompt monetary tightening, but rapid, adverse market reactions and a general sense of responsibility and unwanted consequences among the public. This kind of thinking went completely out the window in the United States in the 1980s with unprecedented private and public borrowing binges.

Whether plunging personal saving, a soaring budget deficit or a soaring trade deficit, none of it mattered anymore for the economy's health in the eyes of American consensus economists. For the first time in history, national and international lenders and investors readily financed extreme American borrowing and spending excesses.

There was still a lively, critical public debate inside America about the negative effects of the soaring budget deficit and lower personal saving on national saving and the pace of domestic capital investment. Net national saving as a percent of GDP declined from around 7% to almost 2% during the 1980s, while net private investment (gross investment minus depreciations) shrank over the same period as a share of GDP from a little over 7% to 5% of GDP. Clearly, this reflected a consumption boom, not a supply-side boom.

AN ENTIRELY DIFFERENT DOWNTURN

We have recalled this episode and the notorious American disregard of economic theory because these negative trends in saving and capital formation that started in the 1980s have dramatically deteriorated in recent years. Measured by the new slide of net saving and net capital investment, consumers and businesses have ravaged the economy's capital structure in the past few years as never before. Yet this time there is zero discussion, zero research and zero worry.

Net national saving has slumped again to around 2% of GDP, and continues to shrink as minimal personal and business saving is being joined by a soaring budget deficit. Net capital investment still accounts for about 5% of GDP, about half-and-half nonresidential and residential investment.

Manifestly, this is not a garden-variety type of economic downturn; that is, one triggered by rising inflation and monetary tightening. Rather, collapsing profits induced businesses to slash employment, fixed capital investment and inventories. The profit slump is the one very unusual feature. The fact that it occurred against the backdrop of the most rampant money and credit growth in history is the other one.

During 2001, broad money growth (M3) accelerated to $912.5 billion, from $573.7 billion in the year before, while GDP growth, measured from fourth quarter to fourth quarter, decelerated to $5 billion. To put this into perspective: Broad money (M3) grew by $468 billion overall, from 1990 to 1995 or $94 billion per year.

Worst of all are the credit figures. In 1991, borrowings of the nonfinancial sector soared by $1,108 billion and those of the financial sector by $916 billion. During the second quarter of 2002, the debt explosion went astronomic. Total nonfinancial debts exploded by $1,531.4 billion (government $451.3 billion, consumers $705.5 billion and businesses $201.1 billion) and financial debt by $916.3 billion, all at annual rate. Altogether, this produced an abysmal increase in GDP of $58 billion, also at annual rate.

One would think that such a horror picture of grossly ineffective record money and credit growth would provoke some critical questions about underlying causes. But we see nothing of that kind. Few, if any, people seem to have noticed.

The past U.S. boom was anything but normal, and so is the downturn. The question to examine in the face of the obvious, massively abnormal features of boom and bust is how, and to what extent, they condition the future, either for better or for worse.

With this question in mind, let us address one major problem after the other one. To start with, one of the greatest worries is certainly the complete collapse of the relationship between money and credit creation and economic activity. How is it possible that the runaway money and credit growth in 2001 barely impacted the economy?

A FRIGHTENING STORY

In 2000, by the way, real GDP had increased by $505.4 billion. Far from being America's mildest downturn in history, this one has been unusually abrupt and steep. But money and credit growth continue at a rampant pace, vastly exceeding GDP growth. It has even failed to help the collapsing stock market, also an unprecedented experience.

Runaway money and credit creation has had minimal effects on the economy and nil effect on the stock market, even after 20 months of aggressive Fed easing. What could be more frightening than this radical disconnect between money, credit, economy and financial markets?

There can be no question that the U.S. economy is at its most critical juncture since the Great Depression of the 1930s. With both the cause and pattern of the present downturn diametrically different from those of prior recessions, it should be clear that past experience cannot be helpful in assessing what is to come.

Extensive statistical research is one thing; identifying the key problems of an economy and assessing inherent economic implications is an entirely different matter that requires much more than statistics. Assessing the U.S. economy's outlook requires a return to basics.

Is there any explanation for this drastic rupture between money and credit growth and economic activity? Indeed there is. It indicates that the proceeds of current borrowing are mostly being used for other purposes than the purchase of domestically produced goods and services, which would increase national income and GDP.

When firms invest into new plant and equipment, the associated credit creation increases GDP. But when

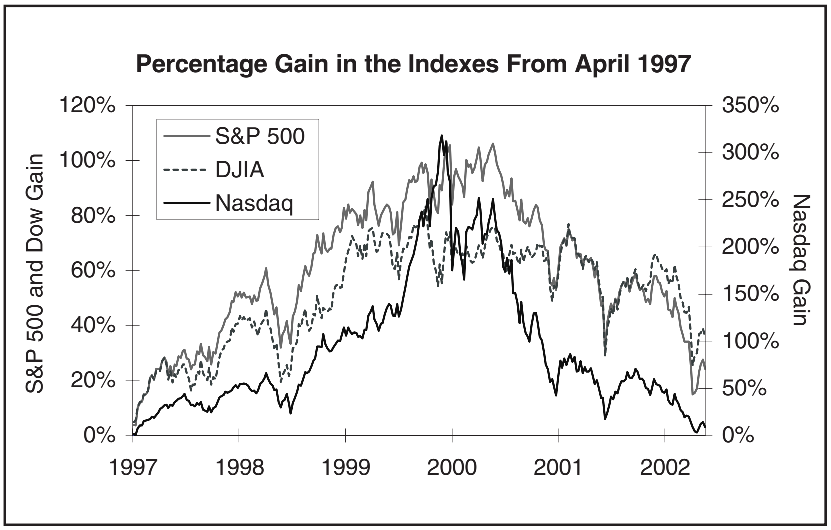
they buy other firms, the associated credit creation leaves GDP unchanged. Borrowing and spending for imported goods, a very big item in the United States, also adds nothing to GDP. Yet the single biggest absorber of the rampant credit creation is, in our view, the soaring bill of compound interest.

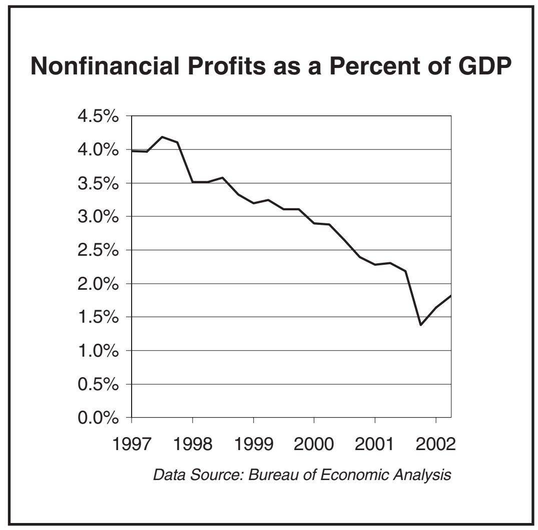
Next or equal in importance is the unusually miserable profit performance that started early in the boom, which is also the key cause of the slump in business fixed investment.

We have to repeat ourselves: Corporate earnings in the nonfinancial sector peaked in 1997, while the economy kept booming until 2000, with nominal GDP up 18%. Corporate earnings fell during these three years from $504.5 billion to $423 billion, or 16%, implying a savage squeeze of profit margins.

While Wall Street was celebrating a profit miracle, profits were effectively slumping — quite a stunning achievement. In apparent response to the New Economy and profit hype, stock prices took off vertically. From the lows in April 1997 to their highs in early 2000, the Nasdaq skyrocketed by 318%, the S&P 500 by 106% and the Dow Jones by 83%. Overall, capital gains in the stock market produced $6 trillion of capital gains.

In hindsight, the period from 1997 to 2000 appears to have been of critical importance for the economic and financial development of the United States. Not only did stock prices shoot into new dimensions of excess, but so did money and credit growth.





American economists like to make optimistic forecasts as much as they dislike explaining their underlying assumptions. It is our long-held opinion that the most important part of any forecast is the explanation of underlying assumptions.

Knowledge of causalities is crucially important. Assessing the business cycle, British and American economists have always tended to stress the role of expectations and confidence. If confidence could be restored, they widely maintain, no real reason would remain why economic growth should not resume. Let us talk prosperity instead of hard times, and all will be well again. Isn't that the essence of what Mr. Greenspan is preaching?

European economists, and also Mr. Mitchell by the way, have never placed faith in these "sunshine movements." In their view, in the end it is nothing but cold, hard economic facts that control the business cycle and economic growth, not simply mood changes. If confidence clashes with the cold facts, the hour of reckoning is bound to come sooner or later.

But what are the "decisive objective conditions" that determine the ups and downs of the business cycle, and how can we identify them? While Mr. Mitchell recommended lots of statistics to spot regular leads and lags, the Continental Europeans emphasized the need for a selective, analytical approach focusing on the crucial determinants of economic growth, which the theoretical concept has to identify.

INVESTMENT VERSUS CONSUMPTION

In essence, Continental European economic theory focuses on capital investment as the critical mass in the growth process. It creates demand, employment, income and tangible wealth, while the plant and equipment are produced. And with their installment, these capital goods create supply, employment, productivity and income. It is the one and only GDP component that has lasting effects.

In economics, it has always been customary to distinguish between "derived" and "autonomous" demand. There is a widespread view in the United States that business fixed investment is largely "derived demand," deriving from rising consumer demand. As businesses see rising consumer demand, they invest; seeing declining consumer demand, they stop investing.

Inherently, this perception assigns the leading role in the business cycle to consumer demand. One of the main arguments is that it accounts for 70% of GDP and more. Where the rise in consumer demand comes from remains unexplained. From this perspective, the recent, sustained consumer borrowing and spending binge is a highly positive feature. But capital investment has nevertheless plunged as never before.

Continental European business cycle theory rigorously disputes this assumption. It starts with the recognition that all incomes ultimately derive from production itself. By deciding about production and investment, the entrepreneur implicitly decides about income growth in the economy. Production and investment, in turn, are guided not by any knowledge of the growth of future consumer demand, but by calculations of their probable profitability.

If the entrepreneur sees adequate profits for his capital, he invests and produces, and as production and investment spending increase, this generates the additional incomes that buy the additional supply. In the capitalistic economy, all questions about current and future growth lead to the one question of reasonable profit prospects and expectations as the incentive for rising capital investment.

As capital investment increases in response to favorable profit expectations, the higher employment in the capital goods industries enlarges consumer incomes. In this way, investment regulates consumption, rather than that rising consumption demand increases investment. In fact, it has been common to all business cycles that capital investment, including housing, has led every downturn as well as every upturn.

We have delved into the history of Continental business cycle theory for two reasons. First of all, it definitely holds the key to the U.S. economy's present downturn; and second, it is largely unknown to English-speaking economists. Nor is it appreciated that Keynesian economics, with its emphasis on business fixed investment as the prime mover of the business cycle, is the logical outgrowth of Continental European business cycle theory.

In his *Treatise on Money*, John Maynard Keynes explicitly confirms its influences on his thinking: *"I find myself in strong sympathy with the school of writers — Tugan-Baranowski, Spiethoff and Schumpeter — of which Tugan-Baranowsky was the first and the most original."*

THE COLD, HARD FACTS

By now it is widely realized that the U.S. economy's present downturn is primarily rooted in a profit and capital-spending crisis. Unfortunately, this knowledge still explains nothing. Pondering the economy's further prospects essentially implies pondering the causes of this profit and capital-spending crisis.

Now to the cold, hard facts about the U.S. economy's sudden, sharp downturn. Actually, its slowdown started in the third quarter of 2000, due to stagnant fixed investment and declining inventories. Negative growth lasted over the first three quarters of 2001 with a $30.1 billion net decline of real GDP.

Plainly, the downturn owed its modest pace to flagrantly divergent movements of consumer and business spending. While nonresidential fixed investment slumped by $123.5 billion in the course of 2001, from fourth quarter to fourth quarter, consumer spending rose by $153.3 billion. In current dollars, by the way, it increased by $303.3 billion. Typically, however, consumption broadly stagnates during recessions.

During the first half of 2002, consumption has grown another $79.8 billion, but as most of that spending went through the soaring trade deficit to foreign producers, very little of it added to U.S. GDP growth. In the end, a slowing rate of inventory liquidation and higher government spending have accounted for the bulk of U.S. GDP growth in 2002.

The important point to see about this recovery phase is that final private demand (consumption + investment – trade deficit) contributed barely $36 billion to the overall gain in real GDP. And even that little bit had a highly dubious source.

On closer look, it emerges that this small increase in final private demand derived more than fully from the famous hedonic pricing of computers. In actual dollars, businesses slashed their investments in computers from $95.7 billion to $73.1.billion, but measured in hedonic dollars they boosted it from $255.9 billion to $273 billion. Its net effect was a gain in real GDP by $39.7 billion. Putting it simply and bluntly: The U.S. recovery is a statistical mirage.

EVERYTHING IS WORSENING

The biggest question of all, of course, is what has to happen to start a sustained and self-reinforcing recovery as has typically followed past recessions. The regular starter was always the loosening of the monetary brakes that had earlier curbed money and credit growth. As interest rates fell, the interest-sensitive and credit-dependent demand components — mainly business equipment, housing and consumer durables — that had led the downturns equally used to lead the later upturns.

Yes, but the present downturn had its main cause in an unprecedented profit implosion, rather than in monetary tightening. The Fed's money spigots have always been wide open, and short-term interest rates have been at record-lows for some time. Considering the persistent money and credit deluge, it is hard to imagine that still easier money and credit will be more successful. See the zero interest rates in Japan.

By now, the evidence is overwhelming that the effectiveness of monetary easing is fatally impaired in the United States. Yet this is something that the great majority of American economists flatly refuse to consider as a possibility.

Mr. Greenspan and many American economists have always saluted the low inflation rates of the past years in the United States as the emblem of the economy's outstanding health. Paradoxically, they took this as a carte blanche allowing and justifying unlimited money and credit creation. Their memory ought to have told them that the worst credit excesses, and in their wake the worst economic and financial crises — America in the late 1920s–'30s and Japan in the late 1980s–'90s — have occurred against the backdrop of zero inflation rates.

Mesmerized by the low inflation rates, policymakers then and today have been making the very same crucial mistake. They flatly ignore the massive maladjustments that the credit excesses are doing to the allocation of resources. In 1928–29 in the United States, the soaring stock market operated to prolong the unsustainable consumer-spending boom while investment spending stagnated. In the late 1980s in Japan, the soaring asset prices gave — through sharply lower capital costs — a massive boost to business fixed investment. As to the present U.S. experience, it is largely a repeat of the late 1920s' pattern in that consumption has taken a rapidly growing share of GDP.

The allocation of available resources between consumption in the present and capital investment for the future is one of the central problems of economic policy. Massive shifts between the two were the hallmarks of those two historical bubbles. The protracted recessions that followed were due to the fact that the necessary readjustment in the resource allocation needs much more time than an inventory liquidation.

In his recent speech in Jackson Hole about economic volatility, Mr. Greenspan hailed it as a great achievement in the United States that *"economic imbalances in recent years apparently have been addressed more expeditiously and effectively than in the past, aided importantly by the more widespread availability and more intensive use of real-time information."*

This statement is truly ludicrous. Instead of curbing his spending excesses, the consumer has stepped up his borrowing and spending binge; the trade deficit has seen a new spurt; the profit and investment crisis shows no signs of abating, the government's deficit is soaring, and Mr. Greenspan speaks of an unusually rapid correction of imbalances.

THE LAST STRAW: PRODUCTIVITY GROWTH

Today's U.S. economy has many problems. The obvious, central problem, though, is the unusual profit carnage and the associated capital-spending crisis. Without a radical reversal in profits, a Japanese-style, prolonged stagnation appears inescapable.

All the more astonishing is how little attention this all-important theme is finding among policymakers and economists. The one catchword that has come to dominate the economic discussion in the United States is the sustained, stellar productivity growth. In the Bush administration's first annual *Economic Report of the President*, the White House economists say that the New Economy is "alive and well" with the U.S. economy enjoying "a more rapid rate of long-term productivity growth than other major industrialized economies."

The economists emphasize that "structural," that is, underlying or trend productivity growth, has more than doubled over the last five years, picking up from an average annual rate of 1.37% from 1973–1995 to an average annual rate of 3.07% during 1995–2002.

It has struck us for some time that Mr. Greenspan in particular, but also most American economists, keeps hailing productivity growth as the most important measure of an economy's health and strength. Above all the fact that its high rate of growth has persisted during the economy's downturn is the conclusive evidence for them of a lasting improvement.

This grossly contrasts with the thinking in classical economics. The famous economists of the past thought and wrote very little about productivity growth. Their concern was with capital investment as the key source both of productivity growth and wealth creation. It is peculiar to American economists to focus exclusively on productivity growth while grossly neglecting capital formation.

Productivity growth, in actual fact, is a very elusive concept. First of all, it is difficult to measure; second, it is a statistical artifact that says nothing about effects and has nil relevance for spending decisions of consumers or businesses; and third, it is most important how it comes about. It makes economic sense when production rises faster than "hours worked," but it makes little or no sense when — as in recent years — hours worked fall faster than production.

MEASURING IS EVERYTHING

The 1995 *Economic Report of the President* described the measurement of productivity growth as follows: *"Roughly speaking, official measures of labor productivity are calculated by dividing the nominal output of a given sector (e.g. the private nonfarm business sector or manufacturing sector) by an estimated price index and a measure of hours worked. The trends in all three of these variables are subject to measuring error."* We would add just one word to the last sentence — subject to *considerable* measuring error.

The problem of measuring productivity growth begins with the fact that there are no strict rules for measuring real GDP growth. In 2000, U.S. businesses spent $93 billion on new computers. But measuring real GDP growth, the government statisticians did not use this figure. Claiming a tremendous increase in computer power, they instead inserted a figure based on so-called hedonic pricing: $246.4 billion. That, implicitly, gave a corresponding boost to real GDP growth, and in its wake to productivity growth.

Furthermore, in 1998, they decided to no longer treat business computer software expenditures as a business expense but as investment that is capitalized in the business accounts. With a stroke of the pen, the two statistical changes added massively to the measured level of real GDP, and accordingly to the measured level of productivity.

A watershed event in U.S. GDP statistics that has found even less attention were the changes that took place

in response to recommendations of the "Advisory Commission to Study the Consumer Price Index," better known as the "Boskin Commission," published in 1996.

In its final report, the Commission stated that America's reported inflation rates were overstated by about 1.1 percentage points per year due to failure to take quality improvements and changes in the pattern of buying into account. It is officially estimated that prompt corrective action by the government statisticians reduced the measured inflation rate by 0.8 percentage points per year. Of course, this equally added to real GDP and productivity growth.

It is not difficult to calculate from the available information and figures that, when taken together, these three statistical effects accounted for more than all of the U.S. economy's stellar productivity improvement that has been reported for the last five to six years. Implicitly, they added to measured real GDP and correspondingly to productivity growth, while adding nothing to business revenues in terms of current, payable dollars.

PRODUCTIVITY BOGUS

It should be clear by now what specifically lubricated the speculative frenzy on Wall Street during the past five to six years: vastly excessive money and credit creation and fantastic profit forecasts, promises and expectations. The plausible logic behind the alleged profit miracle was an alleged productivity miracle. Historically, in fact, strong productivity growth has always highly correlated with strong profit growth.

America's present opposite experience is the great exception to this rule. For us it has been the first major reason to question the accuracy of the productivity numbers. Looking at the economy as a whole, we principally focus exclusively on aggregate profits, as reported by the Commerce Department within its national income and product accounts.

Strikingly, for years these numbers have been putting the lie to the stellar profit performance that the companies individually reported. We had no idea of all the accounting tricks with which they inflated their reported profits in order to please Wall Street and investors, and to fill their own pockets. But what we saw, "pro forma" nonsense earnings and option accounting, for example, was quite enough for us to discredit corporate profit reporting as a whole. All these manipultations were eagerly accepted as long as the market soared. Apparently the common desire for higher stock prices justified everything.

The general, comforting explanation is that the income gains from the high productivity growth went overwhelmingly or fully through lower prices and higher wages to the consumer. In actual fact, it went into rising unemployment. This, in turn, is believed to boost profits. But profits plunged. There is nothing beneficial in this development.

Moreover, America's inflation rates of the last few years were low only in comparison to the high rates of the 1970s. Against today's international inflation standards, they are anything but low. Producer prices of finished goods rose overall by 8.9%, or 2.2% per year, between 1997 and 2001. Coming on top of the reported rate of productivity growth of 11.8%, or almost 3% per year, during this period, price and productivity increases jointly added up to more than 20%, or 5% per year, during the four years. If these numbers were correct, they would, indeed, have implied a profit miracle.

For many reasons, we never bought the notion of a New Economy profit and productivity miracle in the United States. Macroeconomic theory, above all, warned us. Conspicuously, in the past few years the U.S. economy has experienced a massive dislocation in the use of its resources towards consumption, accounting for 90% of real GDP growth between 1997 and 2001.

Its counterparts in the economy were exploding debts, collapsing domestic saving, a catapulting trade deficit and record-low net capital investment. From a macroeconomic perspective, such a development implicitly ravages productivity and profit growth. In the case of profits, the numbers manifestly prove it. In the case of productivity, the statistical distortions, as earlier explained, have effectively obscured it.

PROFIT MUDDLE

In his semiannual report to the Congress in July, Mr. Greenspan noted that NIPA profits, being based on tax data, are less susceptible to manipulation and hence more reliable than the profits reported by the corporations. It certainly had not escaped his attention that this profit measure, after four years of steep decline, has slightly recovered. Most strikingly and in diametric contrast to the experience of past years, NIPA profits have been outpacing calculated S&P profits. Many regard this as a hopeful sign.

Importantly, gains in portfolio shares are excluded in NIPA numbers but included in most S&P numbers. Option-generated personal income is an employee expense in NIPA profits as reported to the IRS, while corporations and S&P used to ignore them in their profit calculations.

Certainly NIPA profits are the most reliable profit gauge. That is why we have always focused on them. But there is a big snag. Those tax data are available with a delay of two to three years. In the interim, it uses estimates that are guided by the quarterly corporate financial reports. While later revisions used to be quite moderate, they abruptly went berserk in the last few years.

The NIPA figures actually never showed any exceptional improvement in underlying U.S. corporate profitability, neither in the 1980s nor in the 1990s. According to the original estimates, nonfinancial profits had increased by 12.8% between 1997 and 2000, or 4.2% at annual rate. This was already anything but a profit miracle. But the following benchmark revisions — first to $491.8 billion in 2001 and lately further down to $423 billion in 2002 — turned the earlier reported modest profit increase into profit carnage, reflecting a steep fall by 27%.

Over the four years until 2001, these profits plunged by 33.8% and manufacturing profits by 57.5%. It is already the worst profit decline since 1930, and what's more, it did not start with the economy's decline but years before, while it was booming.

PROFIT REVISIONS (IN $BILLION)

	1997	1998	1999	2000	2001
Nonfinancial sector	512.3	502.4	530.4	577.9	
Manufacturing	214.4	192.8	181.6	185.0	
FIRST REVISION IN JULY 2001					
Nonfinancial sector	504.5	478.8	467.8	491.8	371.4
Manufacturing	196.2	164.3	163.7	155.2	79.5
SECOND REVISION IN JULY 2002					
Nonfinancial sector	504.5	478.8	455.9	423.0	333.7
Manufacturing	196.2	164.3	163.7	159.8	83.4

Source: Survey of Current Business

The size of these latest revisions was very unusual, and just as unusual, though obvious, was their main reason. Belatedly, the tax data revealed unforeseen, massive exercises of stock options in 1999–2000. While financial corporate reports ignore them, the NIPA treats them as an employee expense.

For the very same reason, the relationship between the two profit measures has lately completely reversed. NIPA profits look better because the collapsing stock values have drastically curbed the exercise of stock options, implying an equal drop in wage expenses in the NIPA accounts. In this way, the plunging stock market has statistically boosted profits.

MACRO LOGIC DEFEATS MICRO LOGIC

We are coming to the two all-important questions about the U.S. economy: first, what are the causes of this extraordinary profit carnage; and second, are these causes on the mend or worsening?

Although the unusual profit carnage is definitely the most conspicuous phenomenon of the U.S. economy's downturn, it finds amazingly little attention. Most Wall Street analysts just keep making highly optimistic profit forecasts. Yet a minority of economists has started to implore the danger of deflation for America and the rest of the world. This view says that American corporations have been caught in a vise between rising labor costs and tough, global competition restricting their ability to raise the prices of their products. Strong international competition, according to this the argument, has broken general pricing power.

Both the timing and vehemence of the profit squeeze make, in the first place, a compelling case for the assumption of long-term structural, as against short-term cyclical, causes. But what exactly are these structural causes? For the time being, the one and only answer cropping up in the discussion is deflation, described as a lack of pricing power to cover rising costs, due mainly to strong global competition.

We rigorously contradict. First of all, talk of deflation appears absurd in the face of the most rampant money and credit creation in history; second, in reality only the manufacturers of consumption and capital goods are fully exposed to global competition, accounting for less than 15% of GDP; third, the severity of the profit squeeze is irreconcilable with the reported productivity miracle; and fourth, business profits are predominantly influenced by the decisions of businesses and consumers to invest, save, import and export.

Principally, profits reflect business revenues in excess of business costs. To attribute major diversions between the two flows mainly or exclusively to changes in the price indexes is amazingly naive. Far more important in their impact on profits are changes in the decisions of consumers and businesses to save, invest, import and export.

The people talking of deflation seem to regard consumer spending as the main source of business profits. In this respect, too, they are grossly mistaken. The main source of business revenues is business spending itself. But businesses spend on two different kinds of goods that have totally different macro- and microeconomic effects — expenditures on plant and equipment and expenditures on intermediate goods.

Expenditures on plant and equipment are capitalized both in the GDP accounts and in corporate balance sheets. Spending on intermediate goods, in contrast, finds no entry into GDP and ranks in corporate accounts as expenses. This difference in statistical treatment has a specific economic logic. But while it may make sense to disregard business expenses in the GDP statistics, these expenses account for a very large part of economic activity.

According to Federal Reserve statistics, the product of U.S. manufacturing in early 2002, measured in chained dollars, had an overall value of about $2.7 trillion at annual rate. Consumer goods accounted for around $1,320 billion, business spending on equipment for $751 billion, and business spending on intermediate goods for $622 billion, both together adding up to $1,373 billion.

It should be clear what happens when businesses retrench. Of course, they curb both kinds of spending — that on capital goods and that on intermediate goods — essentially with negative, corresponding income effects. Business retrenchment is taking place on a much broader scale than is generally assumed. That is one point to see. The second one is that for the business sector as a whole, spending cuts are no solution for a profit squeeze because all such cuts reduce business revenues as well as business costs. In the aggregate, there can be no gain for profits. Rather, they spell deepening recession and worsening profits. Negative macro logic defeats positive micro logic.

DISMAL PROFIT PROSPECTS

Profits are produced by specific macroeconomic flows of funds. Assessing general profit prospects boils down to tracing the major flows that affect business revenues and expenses. The single most important profit

source in the capitalist economy, as we have repeatedly explained, is net fixed investment. This qualification arises from the fact that, from a macroeconomic perspective, investment spending creates business revenue without generating business expense.

This sounds rather enigmatic, but with a little knowledge of bookkeeping, it is easy to understand. On the one hand, there are those firms that build the plant and manufacture the equipment. They have a corresponding rise in revenues. On the other hand, there are the firms that make the capital investments. They, in turn, incur no immediate expense because they capitalize these expenditures in their balance sheets. The expenses come later and gradually with the depreciation charges. Looking at the business sector as a whole, aggregate net investment growth equals aggregate net profit growth.

It is generally not realized that this typically largest profit source of a capitalist economy has been badly lagging in the United States over the past several years. Between 1997 and 2001, nonresidential capital spending was up only 20%, averaging just 5% per year. But as capital investment has substantially shifted toward short-lived new high-tech equipment, the pace of depreciations accelerated to an average of 8.4% per year. Net fixed non-residential capital investment was $268.1 in 2001, as against $243.1 billion, after $407.3 billion. That is a little more than zero.

Yet the single biggest drag on U.S. profits, according to this flow-of-funds analysis, has been the skyrocketing trade deficit. From 1997 to second quarter 2002, exports have grown overall by a miserable 0.3%. This compares with import growth by 32%. Imports exceeded exports in the aggregate by an amount of $1,315 billion.

For the bullish consensus, this import surplus is one of the hallmarks of superior American dynamism, primarily reflecting huge capital inflows being attracted by superior rates of return in the United States. Never mind that the trumpeted profit miracle was in reality a profit disaster. But this was, of course, the problem of the foreigners who poured their money and capital into an economy with collapsing profits.

American policymakers and economists, on their part, are the victims of another, portentous error concerning the explosive rise of the trade deficit. It is obviously completely unknown to them that it has been the main cause of the savage U.S. corporate profit squeeze since 1997.

The key point here is the source of the money that flows out to pay for the import surplus. Most of it comes from wages and salaries paid by domestic businesses to workers. In other words, it comes overwhelmingly from business expenses. To the extent that the workers buy domestic goods, it returns to businesses as revenue, being neutral for profits. But to the extent that the workers buy foreign goods, this money deserts the domestic producers. They end up with expenses failing to return. In essence, each dollar of an import surplus is a dollar less in business revenue.

Assessing the U.S. economy's profit prospects, we focus on four particular flows of funds that directly augment or diminish corporate profits. They are business net investment, the trade deficit, personal saving and interest rate expenses.

First of all, it has to be realized that, as a share of GDP, before-tax earnings of nonfinancial corporations are down to a postwar low of 3%, even though the recession has barely started. Net investment is exposed to a negative double whammy from declining new investment and rising depreciation charges. As to the soaring trade deficit, a strengthening economy would worsen it; a weakening economy will diminish it, accordingly impacting profits. We expect the latter.

But a new, major threat to U.S. corporate profits is looming from higher personal saving. As the wealth destruction in the stock market is sure to continue, consumers will be forced to return to higher saving from their current income. This directly diminishes business revenues relative to business expenses, implying a corresponding profit squeeze.

Another unusual profit depressant is the corporate interest bill. In all past recessions, falling interest expenses played a key role in boosting profits. This time, they have remained at record-high levels, due to further borrowing and widening yield spreads.

CONCLUSIONS:

U.S. policymakers, economists and the public remain unflinching in their denial of the gravity of the economic and financial situation. Their main problem is a lack of understanding and blind faith in the omnipotence of the Federal Reserve and the efficiency of the markets.

Apparently, it needs persistent emphasis that this economic downturn differs diametrically from all previous postwar cycles. It has not been brought about by tight money but by unsustainable bubble-related spending excesses that have left behind a grossly ill-structured economy and an overextended financial system.

Top among the many structural problems is a depression of profits and of capital spending, propelling each other downward in a vicious spiral. A complementary cause is ravaged balance sheets.

Recessions have to be conceived as periods in which consumers and businesses correct their boom excesses. America is fighting the recession with still more consumer-spending excesses.

Systemic risks in the economy and the financial system are not diminishing but worsening.

Don't expect a new dip of the U.S. economy. Prepare for much worse to come.

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